

Recommendation: **BUY**

Stock Code: 7119

Bloomberg: DGEM MK

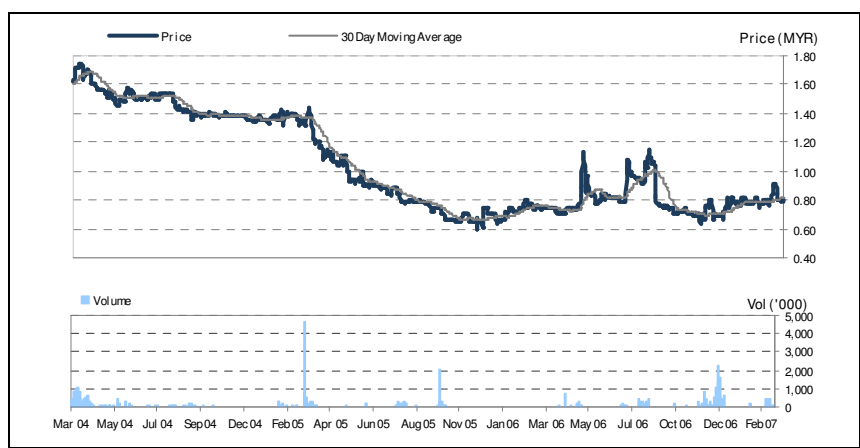
Price: MYR0.785

12-Month Target Price: MYR0.92

Date: March 12, 2007

Board: Main**Sector:** Consumer Products**GICS:** Consumer Discretionary/Apparel, Accessories & Luxury Goods**Market Value - Total:** MYR105.2 mln

Summary: Founded in 1982, Degem is a leading jeweler in Malaysia focused on the domestic trading and manufacturing of diamonds, gemstones, pearls, white gold and platinum jewelry. Listed in October 2001, it was transferred to the Main Board in June 2003.

Analyst: Alison Seng

Results Review & Earnings Outlook

- Degem reported revenue and net profit of MYR144.2 mln (+33.3% YoY) and MYR12.7 mln (+174.9% YoY) in 2006. Stripping out the exceptional gain of MYR2.8 mln from the restructuring exercise, net profit would be MYR9.9 mln (+114.2 % YoY). The results were ahead of expectations due to higher-than-expected sales and margins.
- 2006 sales were robust driven by increased consumer spending and effective promotional and marketing initiatives. Domestic sales grew 28.7% YoY to MYR124.5 mln while overseas revenue increased by 72.1% YoY to MYR19.7 mln.
- Gross profit margin declined to 31.3% from 35.6% due to an increase in commodity prices, but the containment of operating costs, exceptional income and a lower effective tax rate helped improve the pre-tax profit margin to 12% in 2006 from 7.4% in 2005. Excluding the one-off income from the restructuring exercise, the pre-tax profit margin still improved to 10.1% from 7.4%. The effective tax rate dropped to 26.9% in 2006 from 41.3% in 2005.
- Degem expects revenue to grow in tandem with the growth in consumer demand given the continuing improvement in the economic situation. We are raising our 2007 and 2008 net profit forecasts by 26.8% and 26.5% after adjusting our revenue assumptions.

Key Stock Statistics

FY Dec.	2006	2007E
Reported EPS (sen)	9.5	8.2
PER (x)	8.3	9.6
Dividend/Share (sen)	16.5	6.0
NTA/Share (MYR)	0.72	0.80
Book Value/Share (MYR)	0.78	0.86
No. of Outstanding Shares (mln)	134.0	
52-week Share Price Range (MYR)	0.64 - 1.15	
Major Shareholders:	%	
Legion Master Sdn. Bhd.	51.7	
Employees Provident Fund	8.7	

Recommendation & Investment Risks

- We have increased our 12-month target price to MYR0.92 from MYR0.84 after revising our earnings forecasts and rolling over the discount period. We are maintaining our Buy recommendation given the potential upside of 17% to our target price.
- Degem's earnings have normalized following the poor performance in 2005, reflecting the success of its restructuring exercise. In October 2006, Degem's wholly owned subsidiaries acquired a combined 60% stake in Degem Masterpiece Pte Ltd in Singapore. We expect the company to sustain its profitability through both domestic and overseas expansion. Domestic and overseas contributions to revenue were 86.3% and 13.7% in 2006 (vs. 2005: 89.4% and 10.6%) respectively.
- Our target price is based on DCF analysis. Key assumptions include: 2007-2010 FCF CAGR of 6.3%, terminal growth rate of 3% (unchanged) and WACC of 9.6%-10.5%(vs. 9.5%-10.4% previously). Our target price includes a projected net DPS of 4.3 sen. Our new target price implies a fair 2007 PER of 11.2x, which is more in line with Degem's historical median PER of about 11.3x.
- Risks to our recommendation and target price include failure to secure good shopping mall locations for future store expansion in Malaysia and unsuccessful overseas expansion.

Per Share Data

FY Dec.	2004	2005	2006	2007E
Book Value (MYR)	0.76	0.82	0.78	0.86
Cash Flow (sen)	9.8	4.9	8.8	9.9
Reported Earnings (sen)	8.4	3.5	9.5	8.2
Dividend (sen)	3.0	2.5	16.5	6.0
Payout Ratio (%)	27.4	52.3	161.3	52.3
PER (x)	9.4	22.7	8.3	9.6
P/Cash Flow (x)	8.0	16.2	9.0	7.9
P/Book Value (x)	1.0	1.0	1.0	0.9
Dividend Yield (%)	3.8	3.2	21.0	7.6
ROE (%)	11.5	4.5	9.2	10.0
Net Gearing (%)	25.4	25.7	25.6	18.3

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Quarterly Performance

FY Dec. / MYR mln	4Q06	4Q05	% Change
Reported Revenue	42.3	26.2	61.5
Reported Operating Profit	NA	NA	NA
Depreciation & Amortization	-0.6	-0.5	24.6
Net Interest Income / (Expense)	NA	NA	NA
Reported Pre-tax Profit	3.7	-0.3	NM
Reported Net Profit	2.9	-0.1	NM
Reported Operating Margin (%)	NA	NA	-
Reported Pre-tax Margin (%)	8.7	-1.0	-
Reported Net Margin (%)	6.8	-0.5	-

Source: Company data

Profit & Loss

FY Dec. / MYR mln	2005	2006	2007E	2008E
Reported Revenue	108.2	144.2	156.4	165.8
Reported Operating Profit	9.2	NA	17.6	18.6
Depreciation & Amortization	-1.9	-1.9	-2.3	-2.7
Net Interest Income / (Expense)	-1.3	NA	-2.5	-2.5
Reported Pre-tax Profit	8.0	17.3	15.0	16.0
Effective Tax Rate (%)	41.3	26.9	27.0	26.0
Reported Net Profit	4.6	12.7	11.0	11.9
Reported Operating Margin (%)	8.5	NA	11.2	11.2
Reported Pre-tax Margin (%)	7.4	12.0	9.6	9.7
Reported Net Margin (%)	4.3	8.8	7.0	7.2

Source: Company data, S&P Equity Research

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Strong Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.

Hold: Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.

Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.

Strong Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

S&P 12 Month Target Price – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

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Required Disclosures

Recommendation and Target Price History

Date	Recommendation	Target Price
New	Buy	0.92
6-Dec-06	Buy	0.84
17-Aug-06	Hold	1.12
22-Jun-06	Hold	0.87
1-Mar-06	Strong Sell	0.40
5-Jan-06	Strong Sell	0.45

